Supreme Court, U.S.
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No. 01-603

In The

Supreme Court of the United States

DELUXE CORPORATION,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

REPLY BRIEF FOR PETITIONER

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RULE 29.6 STATEMENT

Deluxe Corporation does not have a parent company, nor does any other publicly held company own 10% or more of Deluxe Corporation's stock.

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REPLY BRIEF FOR PETITIONER

Respondent makes essentially three points in its Brief in Opposition: (1) that petitioner is challenging settled principles of formula apportionment and this Court's settled decisions upholding those principles (Brief in Opposition ("Br. Op.") i-ii); (2) that respondent's shifting of income from Current and Colwell to Deluxe is consistent with the principles of apportionment (*id.* 13-17); and (3) that this case does not present an issue of ongoing legal significance. (*Id.* 12-13.) None of these points has substance.

First, petitioner is not challenging the unitary business principle or formula apportionment. The petition makes this clear (Petition ("Pet.") 5), and despite arguing to the contrary, respondent eventually acknowledges this point in its brief. (Br. Op. 17-18.) The only issue raised by petitioner is whether California's method of calculating Deluxe's income runs afoul of this Court's warning in *Heublein, Inc. v. South Carolina Tax Commission*, 409 U.S. 275 (1972), that a State may not "evade" the purpose of 15 U.S.C. § 381 ("Public Law 86-272"). Respondent's repeated efforts to recast the issue in this case are an obvious attempt to redirect this Court's attention to matters that are not in dispute.

Second, there is no merit to respondent's contention that the arbitrary shifting of income from Current and Colwell to Deluxe is constitutionally tolerable under the relaxed standards this Court has applied to constitutional challenges to unitary taxation and formula apportionment. *See, e.g., Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994). Those decisions merely uphold the unitary method and formula apportionment; they do not, as respondent contends, "implicitly" support the shifting of income at issue here. (Br. Op. 15.) Third,

respondent's attempt to discount the significance of this case is belied by the interest of amicus and the need to clarify whether States may in effect override a limitation of state taxing power enacted by Congress.

Respondent has made no serious effort to defend the arbitrary shifting to Deluxe of income attributable to Current's and Colwell's California activities. Respondent does not even address this issue until the tail end of its brief, where it advances the strained argument that the shifting of income is required because the State has no "interest" in calculating the income of nontaxable corporations (Br. Op. 19), and then it merely repeats the point that the shifting of income is supported by formula apportionment principles. (*Id.* 19-22.)

I. THIS COURT'S "UNITARY TAXATION" AND "FORMULA APPORTIONMENT" CASES HAVE NO BEARING ON THE ISSUE RAISED BY THIS CASE

Throughout its brief and using different formulations, respondent repeatedly mischaracterizes the issue in this case as whether California has properly apportioned the income of Deluxe's unitary group to that State: "may California constitutionally determine the California source income of the taxable member of a unitary group (*i.e.*, Deluxe) by using an apportionment formula that takes into account the apportionment factors of all members of the group" (Br. Op. i); "[t]he calculation of the numerator of the sales factor is at issue in this case" (*id.* 4); "[t]he dispute in this case involves the method by which California apportioned the Deluxe unitary group's sales under the State's three-factor apportionment formula" (*id.* 5); and "what Deluxe seeks is to erode significantly many decades of decisional authority from this

Court permitting a taxing State to look beyond its borders to arrive at a fair allocation to the State of a fair share of the taxable values of the taxpayer's activities within the State." (*Id.* 13.)

If respondent's characterization of the issue in this case were accurate, petitioner would not be here. Petitioner takes no issue with the widely accepted principle that the income of all members of a unitary group, including the income of nontaxable corporations, is includible in a unitary group's "pot" of income subject to apportionment (Pet. 5); *see, e.g., Shell Oil Co. v. Iowa Dep't of Revenue,* 488 U.S. 19 (1988). Petitioner also does not take issue with California's apportionment formula, including the inclusion of the California sales of nontaxable corporations in the numerator of the sales factor. (Pet. 5.) Petitioner further does not dispute that the amount of the Deluxe unitary group's income apportioned to California in this case was correct and properly reflected the California activities of Deluxe, Current, and Colwell.

What petitioner does dispute, however, is respondent's arbitrary assumption that all of the unitary group's income was solely attributable to Deluxe. Respondent has provided no reasoned basis for the assumption that Deluxe earns all of the group's California income, if Current and Colwell are not taxable, but only a portion of the group's California income, if all are subject to tax.

The indefensibility of respondent's rule that shifts income from nontaxable affiliates to taxable ones has understandably induced respondent to attempt to redirect the focus of its argument from a question petitioner has raised – whether the shifting of income from Current and Colwell to Deluxe violates Public Law 86-272 – to a question petitioner has not raised – whether the unitary

business principle and California's three-factor apportionment formula properly apportioned to California the income of the Deluxe unitary group. (*See* Br. Op. i.) Respondent's goal in redirecting the inquiry is transparent – it seeks to place itself under the umbrella of this Court's decisions that, recognizing the difficulty of ascertaining precisely what share of a group's worldwide income should be assigned to a particular State, have upheld the unitary business principle and formula apportionment. (*Id.* 13-14.) Those cases upholding fair apportionment, and their forgiving constitutional standards, have no application here.

As noted in the petition and in respondent's brief, unitary taxation in California is a four-step process. The cases cited by respondent address only the first three steps of the four-step process – step one, who can be included in the unitary group (Br. Op. 13 (citing *Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994))); step two, what income may be included in the pot to be apportioned among the States (Br. Op. 13 (citing *Shell Oil Co., supra* and *Butler Bros. v. McColgan*, 315 U.S. 501 (1942))); and step three, the constitutionality of the apportionment formula. (Br. Op. 13 (citing *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) and *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931))).

None of the cases cited by respondent have addressed the fourth step – the assignment of the unitary group's California income to each individual member of the group. In the present case, the sole issue before the Court relates to the fourth step – namely, whether respondent's arbitrary assignment of income is an indirect means of taxing the income of Current and Colwell, in violation of Public Law 86-272. *See Heublein, supra*. The decisions relied upon by respondent neither implicitly

nor explicitly considered whether it is proper for a State to assign a unitary group's apportioned income on a pro rata basis when all of the members of the unitary group are taxable, but to abandon the pro rata rule and assign all of that income only to taxable members when one or more of the members are immune from taxation. The authorities relied upon by respondent are simply inapposite to the primary issue here.

In short, this case does not involve, as represented by respondent, a challenge to unitary taxation or formula apportionment principles. Rather, it involves a challenge to a flawed mechanism that assumes that 100 percent of the income that has been apportioned to California is taxable by that State, regardless of whether any of that income is earned by corporations immune from California tax under Public Law 86-272. This is a question of first impression for this Court and of substantial significance in the field of state taxation.

II. RESPONDENT'S CONTENTION THAT THE SHIFTING OF INCOME FROM CURRENT AND COLWELL TO DELUXE IS SIMPLY A FUNCTION OF APPORTIONING INCOME OF A UNITARY GROUP CANNOT WITHSTAND SCRUTINY

It is undeniable that "Deluxe is paying taxes on income generated in California by Current and Colwell." (Statement of Decision (Appendix ("App.") 21a).)[1]

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[1] Indeed, even respondent acknowledges that the group's California apportioned income was assigned solely to Deluxe because it was taxable, and not to Current and Colwell because those corporations were not taxable in California. (Br. Op. 8.); *see also* Cal. Franchise Tax Bd., Notice No. 90-3 (June 8, 1990) (App. 42a) (explaining that the normal pro rata assignment of a

Respondent provides no meaningful defense of its shifting of income in this case. Its primary defense – that petitioner "misapprehends" the distinction between apportionment and taxation – is wholly without merit. (Br. Op. 17-22.)

Petitioner does not misapprehend the distinction between apportionment and taxation. Apportionment is simply the determination of the unitary group's income that is sourced or attributable to a particular State. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165 (1983). Taxation, on the other hand, involves a separate analysis of the State's power to tax the apportioned income. Indeed, this Court has made clear that taxation occurs after the apportionment process.

> [I]ncome that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. *Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable [to the state's] taxing jurisdiction is taxed by the [State].*

Shell Oil Co., supra at 30 (emphasis added).

In this case, respondent's position rests on the mistaken premise that once a unitary group's income is apportioned to California, it does not matter to which corporation that income is assigned because California may tax all of the unitary group's apportioned income, even that income attributable to corporations protected by Public Law 86-272. (Br. Op. 21 ("Income attributable to California sources, which is the measure of a corporation's tax liability under California statutes, is then

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unitary group's California apportioned income to each member of the group does not apply when a member is immune from tax in California under Public Law 86-272).

assigned to the member or members of the unitary business taxable in the State.").) The critical fault in respondent's premise is that it assumes apportionment and taxation are one and the same. However, just because income is apportioned to California does not mean California may tax that income. Since apportionment and taxation are separate and distinct concepts, California must separately determine whether it has the power to tax the income apportioned to that State. It is respondent, therefore, that misapprehends the essential distinction between apportionment and taxation.

Moreover, respondent's reasoning that the assignment of the California apportioned income solely to Deluxe is required because "California is not interested in, nor does it calculate, the measure of tax of those corporate members of the unitary group that are not taxable in California" (Br. Op. 19) is nonsensical. Even if California has no interest in calculating the income of a nontaxable corporation, it does not follow that California may shift that corporation's income to a taxable corporation and tax that income. That income is simply beyond California's taxing power. *See* 15 U.S.C. § 381; *see also Heublein, supra* at 278.

Respondent further contends that it is proper to assign the apportioned income solely to Deluxe "because [such an assignment] is the sole objective of the entire apportionment process." (Br. Op. 19.) The assignment or shifting of income at issue here is not the "sole objective" of the apportionment process, nor is it even related to that process. This Court has declared that the apportionment process is merely to "determine the portion of a unitary business' income that can be fairly attributed to in-state activities." *Shell Oil Co., supra* at 31 (citing *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 219

(1980); *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 440 (1980)). The shifting of income at issue here occurs after the apportionment process is completed. Moreover, even assuming, *arguendo*, that the state's objective in apportioning income is to assign apportioned income solely to taxable members, the mere furtherance of a state objective cannot save the state's practice from constitutional scrutiny.

Similarly, there is no merit to respondent's contention that it is not possible to segregate each unitary member's income, and therefore it is not possible to assert that income has been shifted from one member to another. (Br. Op. 20.) This defense ignores the state's own rules, which require that a unitary group's income apportioned to California be assigned to each member and reported on each member's tax return, and is belied by respondent's own statements. (*See Id.* 4, "Each individual taxpayer's income attributable to California sources must be determined in order to arrive at its franchise tax liability."); *see also* Cal. Franchise Tax Bd., Legal Ruling No. 234 (Oct. 27, 1959) (App. 47a) (providing for the assignment of apportioned income to each member of a unitary group).

Accordingly, not only is it possible to segregate each unitary member's share of the group's California income, each member is required to do so and does so based on its relative California factors compared to the California factors of the group to arrive at its individual California tax liability. Thus, there is also no merit to respondent's assertion that petitioner is arguing that each corporation's income be computed on a separate accounting basis. (Br. Op. 20.) This assertion is merely another misguided attempt by respondent to recast the issue in this case as a challenge to unitary taxation and formula apportionment principles.

III. THIS CASE HAS PROFOUND STATE AND NATIONAL SIGNIFICANCE

Respondent's contention that this case does not present issues of "ongoing legal significance" is without merit. (Br. Op. 12.) Indeed, respondent's attempt to minimize the significance of this case is belied by the amicus curiae brief filed by the Committee on State Taxation ("COST") urging the Court to grant Deluxe's petition. COST has a membership of over 500 multistate corporations involved in interstate and international commerce. The intense interest COST and its members have expressed in this case, and their deep concern over its widespread implications, demonstrate the national importance of this controversy.

Moreover, the lower court's decision establishes a rule of far-reaching import: once income of a unitary group has been apportioned to California, the State is free to tax 100 percent of such income, even though some of that income is attributable to corporations immune from taxation under Public Law 86-272. This issue has profound national implications for essential constitutional limitations on state taxing power and for Congress's power to regulate state taxation.

Finally, respondent's recently issued regulations provide no reason for this Court to refrain from granting the petition. It is a "well-settled" rule that "a defendant's voluntary cessation of a challenged practice does not deprive a federal court of its power to determine the legality of the practice." *See Northeastern Florida Contractors v. Jacksonville*, 508 U.S. 656, 662 (1993); *City of Mesquite v. Aladdin's Castle, Inc.*, 455 U.S. 283, 289 (1982). Applying this settled principle, this Court in *City of Mesquite* concluded that although the challenged statute had been eliminated while the case was pending in the Court

of Appeals, the case was not moot, because the defendant's "repeal of the objectionable language would not preclude it from reenacting precisely the same provision if the District Court's judgment were vacated." *City of Mesquite, supra* at 289.

The reasoning applied in *City of Mesquite* applies with even more compelling force here. Although the new regulations attempt to cure the taxation of corporations that have California sales and that are protected by Public Law 86-272, the regulations do not provide the same treatment for nontaxable corporations with California property and payroll. Thus, even after the new regulations are taken into account, California would continue to tax income protected by Public Law 86-272. (Pet. 6 n.1.) Moreover, since respondent's new regulations apply prospectively only, they do not cure the violation of Public Law 86-272 that is the core issue here. Cal. Code Regs. tit. 18, §§ 25106.5(c)(7) and 25106.5(g).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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